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Business in Brief

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THE CHASE MANHATTAN BANK

The economy is now undergoing its third post-war recession. Business activity turned down in the fourth quarter after having moved along at a high and stable level for nine months.

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The immediate cause of the downturn was an abrupt shift in inventory policy. Business added to inventories at a $2 billion rate in the third quarter. In the fourth quarter stocks were being reduced at an estimated rate of $3-4 billion. This shift reduced demand by $5-6 billion, and accounted for two-thirds of the decline in industrial output.

The inventory adjustment was reinforced by actual and prospective declines in other areas:

¶ Business investment in new plant and equipment declined moderately in the fourth quarter, and surveys show that further declines are in store for 1958.

¶ Exports have already moved down from their phenomenal $20 billion rate early last year. Some further reduction may result as other nations move to balance their dollar accounts.

¶ National Security expenditures were reduced about $1 billion between the second and fourth quarters of 1957. New orders were cut back sharply.

Taken alone, none of these reductions is large in relation to our economy. Yet, added together, they explain the downturn in business.

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Now that we are in a recession, the pertinent questions are: How deep will it be? How long will it last?

So far, the pattern seems to fit that of moderate recessions like 1953-54 rather than deeper ones. Studies of the National Bureau of Economic Research show that the behavior of key indicators in the early months of a downturn may shed light on its extent and duration. To date, such series as new orders, contract awards, industrial production are behaving much as they did in 1949 or 1953 – and not as they did early in more severe recessions.

It is, of course, too soon to draw firm conclusions from such observations. It is still possible that the downward forces could feed on each other and generate a more severe decline.

The element of confidence may be particularly important in shaping business trends in 1958. A consensus that the nation would remain secure and prosperous was an underlying reason why the recessions of 1949 and 1953-54 were moderate.

The climate of confidence is less favorable today. Most industries have excess capacity, consumers are well-stocked with durable goods, and the feeling of national security has been disturbed by recent events.

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There are, however, three factors that could operate to sustain confidence:

¶ The nation is gearing itself to meet the Soviet challenge – among other things, this means increased National Security expenditures;

¶ The so-called "built-in stabilizers" tend to sustain incomes – tax liabilities decline and unemployment insurance and old age pension payments rise;

¶ Action by the Federal Reserve to ease credit operates on the side of moderating the business decline.

These influences are just beginning to be felt. As they take hold, they could cushion the impact of the adjustments in inventories, exports and investment.

Up to now, the major impacts have come from the minus factors. The shift to inventory liquidation has hit hard, as it usually does in the first stages of a business downturn. Some further decline in demand in the other areas of adjustment is indicated.

However, it may be that a major part of the shock has already been absorbed. Further inventory adjustments are unlikely to be comparable to the $5-6 billion swing in this item during the fourth quarter. The Defense cutback is behind us, and Defense orders should pick up. A Commerce Department survey suggests that the lion's share of the planned cut in business fixed investment may come in the current quarter.

If these diverse trends should produce a flattening of the business decline, confidence would be bolstered. As in 1949 and 1953-54, actions based on a feeling that prosperity would return before long could help keep the recession moderate. Such a development would demonstrate once again that the nation's economic future need not be impaired by necessary adjustments that involve moderate recessions in over-all activity.

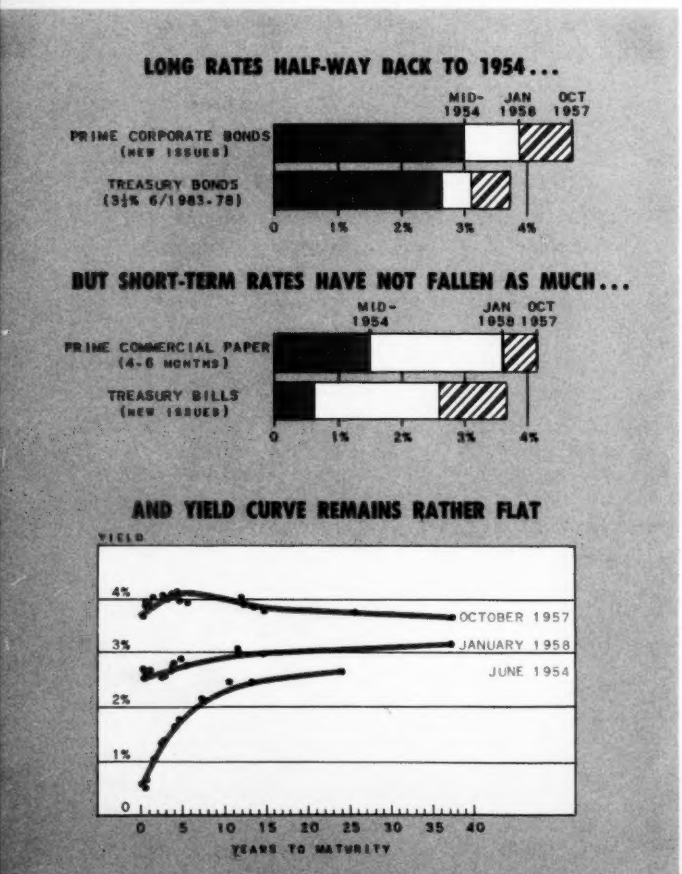
TURNABOUT IN THE MONEY MARKETS

Nowhere has there been a more dramatic reaction to the business downturn than in the money markets. A one-half per cent reduction in the Federal Reserve Banks' discount rates in mid-November provided the first official recognition of the passing of inflationary pressures. That action sparked a rush for bonds in an effort to anticipate a lower rate structure. As a result, prices of many high-grade issues jumped 6 to 8 points in the short space of six weeks, an advance virtually without parallel in the memory of market professionals.

A heavy calendar of new financing is currently providing the market with its first major test of the new level of bond prices. Meanwhile, short-term market rates continued to slip lower during much of January. The Federal Reserve Bank of Philadelphia led in a further reduction of the rediscount rate, with a decrease from 3 per cent to 2¾ per cent, while commercial banks reduced the rate they charge to selected customers from 4½ per cent to 4 per cent.

Current Interest Rates in Perspective

In mid-1954, in the midst of a mild recession, long-term Treasury bonds were selling close to 2½ per cent, while new corporate bonds of prime quality could be floated at less than 3 per cent. Short-term rates were much lower; Treasury bills at one point were issued at 0.62 per cent. These rates were only slightly above the low yields maintained through World War II.



Over the following three years, rates for all maturities moved sharply higher. A persistent tendency for investment demands to outrun savings, combined with an increasingly restrictive monetary policy, had by the summer of 1957 produced the highest structure of interest rates in a quarter century.

Since last October, yields for long Treasury and corporate issues have dropped by about one-half to three-quarters per cent. In the case of Treasury bonds, roughly half of the rise in yields during the previous three years. has been wiped out. Some short-term market rates have also dropped by one-half per cent or more. But relative to the advance since 1954, the easing in the short-term area has been much less spectacular, even though such rates are normally much more volatile and sensitive to changing credit conditions.

Shifting Demands for Credit

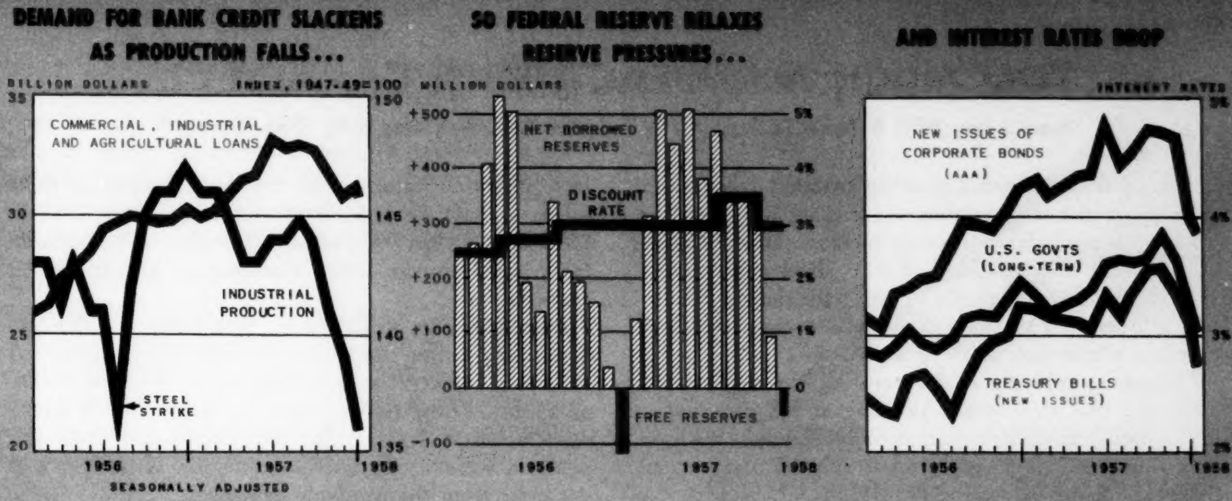
The steep decline in long-term rates is all the more impressive in the face of the fact that demands for long-term funds so far have remained heavy.

- Although most analysts expect that capital needs of businesses will be substantially reduced later in the year, the current schedule of corporate financing is comparable to that of early 1957.
- New municipal financing was at a near-record level of $6.9 billion last year. The outlook is for little or no let-up in the flow of offerings in 1958.
- The Treasury has twice tapped the long-term market since September, following a two year lapse in bond financing. Further funding of the public debt may have high priority.
- Housing activity shows some signs of moderate strengthening, promising an attractive outlet for new mortgage funds.

In contrast to the relative strength of current demands for long-term capital, a significant slackening in needs for short-term bank credit has been apparent for some months. Business loans of the Weekly Reporting Member Banks declined by $885 million from mid-1957 to early January; over the same period a year earlier, such loans increased by $1,909 million.

Against this background, the fact that long rates have moved down about as fast as short-term market rates — thus keeping the yield curve rather flat — appears paradoxical. The key to the paradox clearly lies partly in the fact that the long-term market has rapidly discounted the possibility of substantially easier money and reduced corporate capital financing in the months ahead.

Whatever the longer-run expectations of the capital markets, the Federal Reserve had moved rather cautiously to increase the volume of loanable funds



DATA: FEDERAL RESERVE BOARD AND MOODY'S INVESTORS SERVICE (NEW CORPORATE ISSUES)

through mid-January.

The November discount rate action, while a potent influence on market psychology, did not in itself make funds more freely available to the banking system. Member bank indebtedness to the Federal Reserve at the time was running at about $900 million, thus restraining an expansion in bank assets or deposits. Any strong stimulus to bank lending or investment policy awaited a more ample supply of reserves with which the banks could reduce their borrowings.

Federal Reserve Moves

After November, the Federal Reserve, through open market operations, gradually acted to relax pressures on the banking system. By the turn of the year member banks were able to reduce their borrowings from the Reserve Banks – a matter of first priority – below excess reserves. However, the easing of reserve positions could be traced in part to the failure of loans to follow the usual seasonal pattern of expansion late in 1957, rather than to overt Federal Reserve action.

The total volume of reserves held by member banks at the year end was actually no larger than a year earlier. The inability of banks to expand earning assets aggressively has resulted (after allowing for usual seasonal factors) in some decline in commercial bank demand deposits. And, despite the softening loan demand, the ratio of loans to deposits for many banks, particularly those in the larger centers, remains relatively high.

Contrasts with 1953-1954 Experience

The buoyant response of the long-term markets following the discount rate change and the subsequent caution of the Federal Reserve in releasing reserves provide an interesting contrast to developments in mid-1953, when a mild recession was just getting underway. At that time the Federal Reserve promptly released a massive volume of reserve funds. Banks in turn expanded their portfolios of short-term Treasury issues, and the money supply soon moved higher.

Nevertheless, interest rates were relatively slow to respond. Not until September 1953, two months after free reserves had appeared, did rates begin to drop in earnest towards their 1954 lows. And when interest rates did begin to fall, short-term rates led the way, resulting in a sharply sloping yield curve.

Some Considerations for the Future

There are, of course, some important differences in the business environment as between 1953 and 1957. Nevertheless, the contrasting pattern of money market developments may provide some insight into current Federal Reserve policy.

Thus, the very exuberance of the bond market in late 1957 may have been a factor inducing the Federal Reserve to keep the banking system relatively tight, even after business turned lower. In effect, the long-term capital market has been eased considerably even without completely lifting the pressures from the banking system.

Of longer-run significance in interpreting policy is the emphasis that Reserve Board spokesmen have repeatedly placed on the danger that "creeping" inflation over the years might undermine the American economy. Given this concern, the authorities may not push free reserves to the levels reached in 1954, unless the business adjustment becomes more severe over-all than was the case at that time.

Presumably, the Federal Reserve will maintain its general approach of "leaning against the wind", whatever way the business winds are blowing at the time. Thus, if business does not soon recover from the current downturn, further action to promote greater liquidity in the banking system may be expected.

In that event, short rates might logically be expected to move lower. Further declines in long-term rates, however, may well lag behind, in view of the substantial drop that already has occurred.

TOO MUCH MANUFACTURING CAPACITY?

How Long Will It Take To Restore A Balance Between Capacity And Output?

One of the problems a growing economy faces is that of keeping the various elements making for growth in an appropriate balance. Among the more difficult aspects of achieving this balance is that of keeping the expansion of productive capacity in line with the rise in output. The current situation in manufacturing provides an excellent illustration of these problems.

Companies replying to a recent McGraw-Hill survey estimated that they were operating at 82% of capacity last September, whereas they consider 90% the preferred operating rate. As a result, they reported plans to cut their capital expenditures 16% in 1958.

In short, we have moved ahead too rapidly in building manufacturing capacity. Consequently, we now face a period of adjustment which will involve a sharp reduction in expenditures for expansion. How long is this adjustment likely to last?

Long-Term Trends

For an answer, it is necessary to turn first to an examination of long-term trends in manufacturing. Output of all manufacturing industries has multiplied 5½ times since 1909. However, this growth has not taken place at an even pace:

- The major periods of expansion occurred in 1909-1915 (4.9% per annum), 1920-29 (3.8% per annum) and 1947-55 (6.5% per annum).
- Two World Wars and the depression interfered with the general growth pattern. *The 1929-39 decade is the only period in our recorded economic history during which manufacturing output failed to advance.*

What evidence there is suggests that manufacturing capacity grew at about the same rate as output in most past periods. Contrary to widely-held beliefs, there seems to have been little over-building of capacity in the 1920's. It has been estimated that in 1929 all manufacturing industries were operating at almost 90% of capacity.

Parenthetically, it should be noted that the increase in capacity during the 1920's may have been unbalanced as among industries. In 1929 some industries were operating at over 100% of rated capacity whereas others were down as low as 60%. How significant these imbalances were in the subsequent business downturn is not clear from the available evidence.

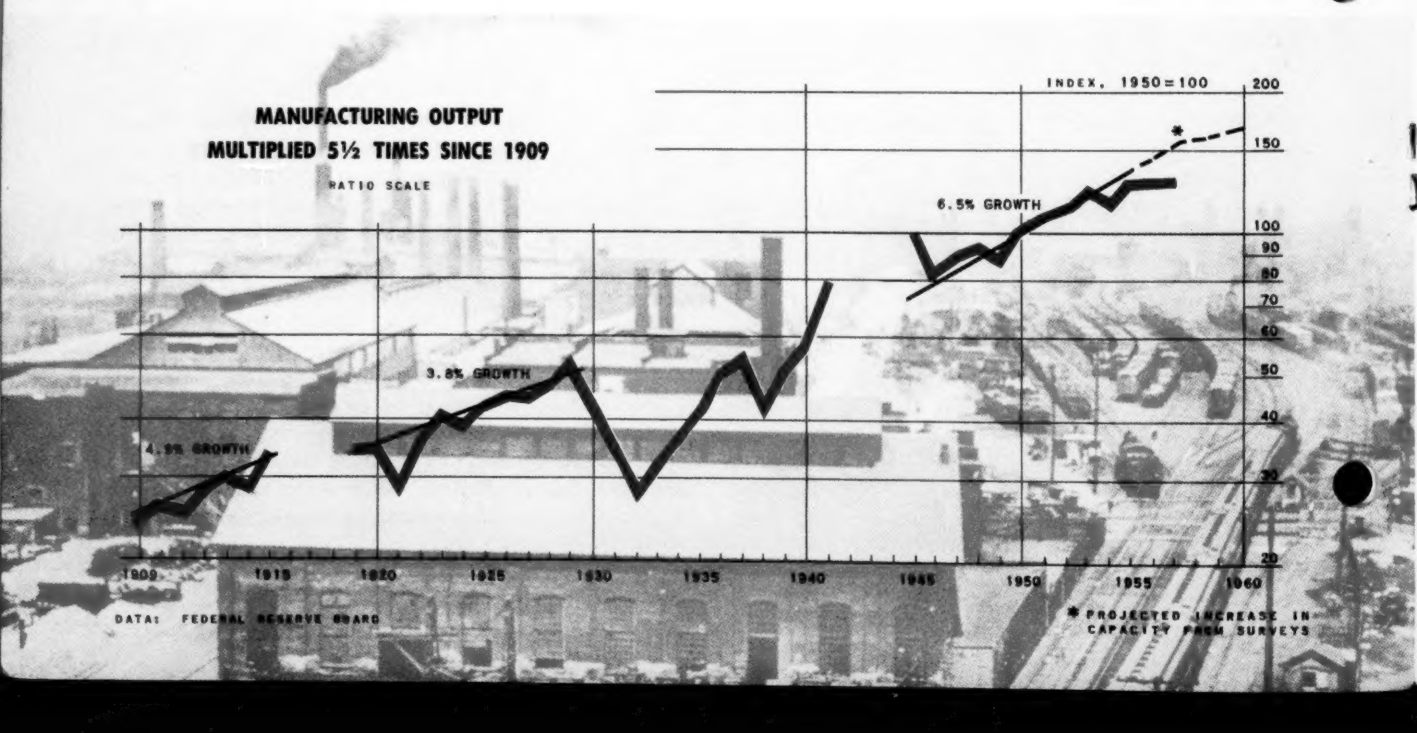
How Much Excess Capacity?

A review of past trends also suggests that a certain amount of excess capacity has been considered desirable by manufacturers. They want enough elbow-room to handle orders efficiently and promptly in periods of good business.

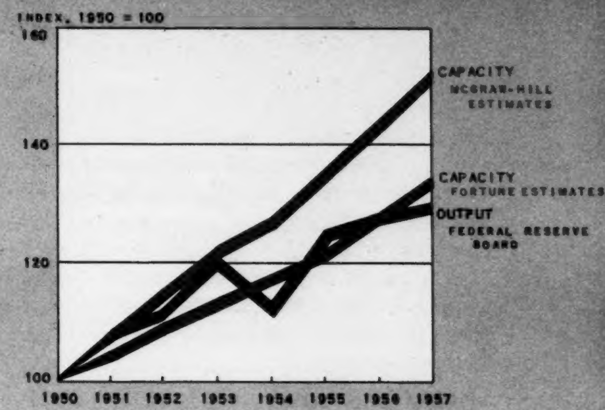
At the same time, it is clear that too much excess capacity is undesirable both from the viewpoint of manufacturers and of the economy as a whole. A general state of excess capacity leads to sharp cutbacks in business fixed investment of the type that may produce a cumulative down-swing in production and employment.

The difficulty lies in deciding when we have enough excess capacity. The existing measurements leave much to be desired (in part because of the very real difficulty of arriving at workable definitions of "capacity" that are comparable among industries).

As a rough rule of thumb, experience suggests that companies move to expand capacity when the operating



HOW CAPACITY AND OUTPUT HAVE GROWN SINCE 1950



That capacity was expanded little faster than output in 1950-55 is shown by two new measures developed by McGraw-Hill and Fortune. For 1955-57, McGraw-Hill shows a 12.7% rise in capacity, Fortune a 9.7% growth.

The McGraw-Hill Survey asks companies how much their "capacity" has grown. Fortune uses statistical techniques. Thus, the results are bound to differ. Yet the fact that both show a more rapid expansion in capacity than in output since 1955 is significant.

rate rises above 85% of capacity as conventionally defined. They look with disfavor on expansion programs when the operating rate sinks below 85%. The precise ratio obviously varies from industry to industry (in part because "capacity" means different things). Yet the generalization of an 85% operating rate as a feasible "normal" finds support in much of the research that has been done.

Postwar Capacity-Output Trends

The perspective furnished by long-term trends helps explain developments during the past decade. It was abundantly clear that we were short of manufacturing capacity at the end of World War II. Thus, companies set out to redress the balance by launching large expansion programs.

As a result, capacity was increased at the very rapid rate of about 6% per annum between 1947 and 1955. However, manufacturing output rose almost as rapidly. We were still short of capacity in 1955 in most lines.

Accordingly, a large expansion program was launched with the dual goals of keeping pace with the normal growth of demand and creating a margin of excess capacity. Many leading steel companies, for example, appear to have framed their investment plans on the assumption that they should prepare for an average operating rate of 85% in prosperous years.

Capacity Out-Paces Output

Expenditures for new plant and equipment rose 40% between 1955 and 1957, a striking gain. However, prices were forced up in the process, perhaps by as much as 20%. In addition, worn-out and out-moded equipment was retired from use. Thus, the real increase in capacity was smaller than the rise in dollar spending would suggest.

The available estimates show an increase of 10-12% in manufacturing capacity between 1955 and 1957. That's about in line with the average annual growth in earlier post-war years.

However, manufacturing output rose only 4% from 1955 to 1957 (and at the end of 1957 it was 5% below its level two years earlier). In other words, today's excess capacity is due largely to the fact that output has shown little growth. The "rolling adjustments" during 1956 and 1957 followed by the downturn in general business at the end of 1957 have held down demand for manufactured products.

Cutback in Expansion

The cutbacks in expansion plans shown in recent surveys point to an annual increase of no more than 2% per year in manufacturing capacity during 1958 and 1959, a sharp reduction from the rate in recent years. About half of manufacturing capital expenditures goes for replacement and modernization, rather than expansion. In the current adjustment, the share of expansion will be reduced, so that a cut of one-fifth to one-quarter in total expenditures may reduce the expansion of capacity from 4-5% last year to 2% this year and next.

Whether this will suffice to restore a balance between output and capacity depends on developments in general business activity. If the current recession should prove no more severe than those in 1949 and 1953-54, economic activity would move ahead again along its long-term growth trends in late-1959 or early-1960. Under these circumstances, many manufacturing companies would find themselves short of capacity to handle 1960 levels of demand.

In other words, the current problem of excess capacity could be worked off in approximately 18-24 months, granted a normal increase in demand for manufactured products. To the extent that the downturn in activity encouraged accelerated retirement of obsolete capacity, the period of adjustment might be shortened. On the other hand, a continued lag in demand would lengthen the adjustment.

In any case, an analysis of the situation does not suggest that fear of an over-bearing amount of excess capacity need be given undue weight in considering future trends in our economy. To the contrary, the fact that we are well-supplied with capacity, and that the expansion appears to be fairly well-balanced as among industries, may prove a genuine source of strength in the next period of general business expansion.

RETAIL SALES

Will They Hold Up in 1958?

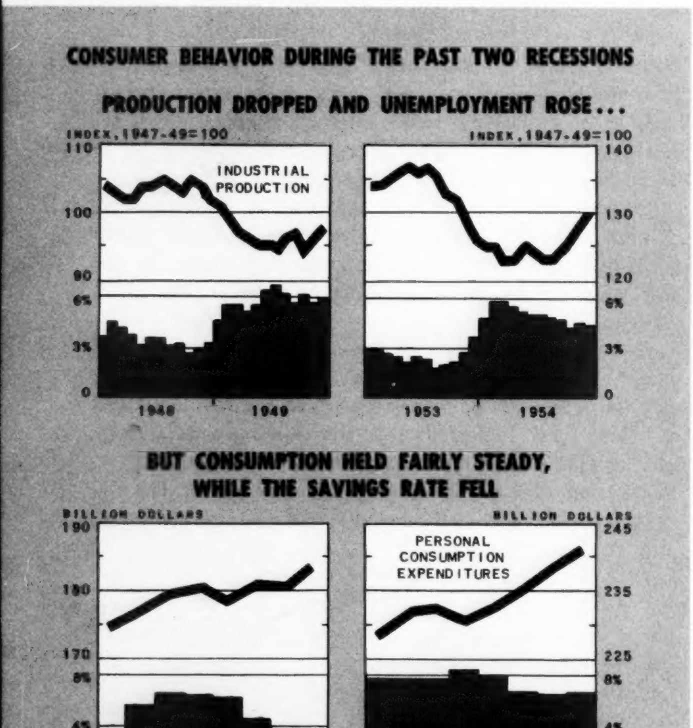
Retail sales showed unexpected strength in December – rising 1% above November and 2% over a year ago. The biggest gains were registered in the nondurable sectors, where sales ran 6% ahead of a year earlier.

Can this strength be expected to continue in 1958? This is a critical point, for consumption generally averages close to two-thirds of total gross national product – almost 6 times as much as investment. The statistics are indeed impressive!

- Since 1946 we've bought 60 million new automobiles, 13 million new homes, and spent well over $1,000,000,000,000 (one trillion dollars) for food and household operations;
- At the same time we've paid out more than $350 billion in the form of personal income taxes;
- Yet we've still found it possible to save $175 billion – about 6.4% of disposable income received during this period.

These patterns of spending and saving are of central significance in analyzing the remarkable growth of our economy in the post-war period.

When World War II came to a close America faced a major shortage of goods. Consumers were extremely anxious to buy, and they had the means to do so because of the sharp rise in savings from 1941-45. In the ensuing decade, as shortage gave way to plenty, consumption rose generally in line with income – almost doubling between 1946 and 1957.



Strength Under Adversity

More important, perhaps, is the consumer record during recessions. In 1948-49 and 1953-54, when industrial production fell by about 10% on both occasions, consumption held up exceedingly well, dipping for only one calendar quarter in each case. And in both instances the declines were limited to little more than 1%.

To be sure, these aggregates tend to conceal certain counter tendencies. Even so,

- Expenditures for consumer durables, which include "postponables" like autos and appliances, dropped by less than 6% in 1948-49 and 8½% in 1953-54;
- Nondurables fell less, as was to be expected. In 1948-49 the dip came to 4% and in 1953-54 it was but 1%;
- Services continued to rise during each period – a trend which has been uninterrupted since 1939.

How, then, can we account for the relative stability of consumption patterns during recent recessions?

Props and Permanent Income

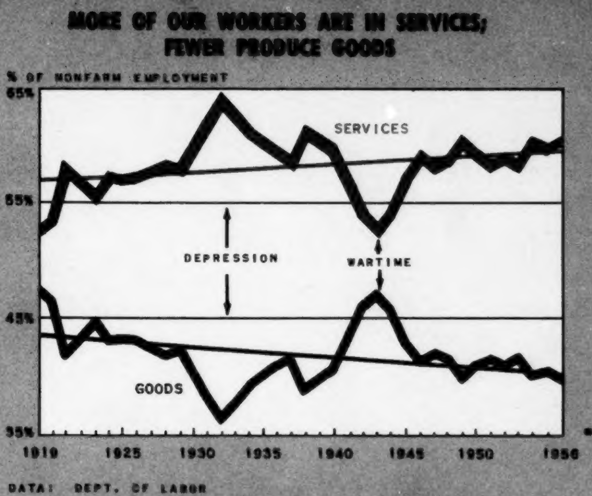
For one thing, income held up well on both occasions. In part this was due to the action of the so-called "built-in stabilizers", such as unemployment benefits. Also, tax cuts in 1954 and mid-1948 served to maintain purchasing power.

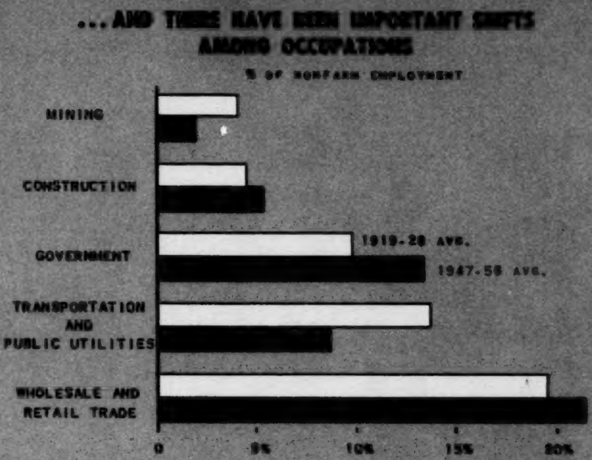
In addition, there is some evidence that consumer habits do not follow every minute change in income. Rather, spending seems to be related to "permanent" income – an individual's estimate of his longer run flow of income rather than the temporary aberrations in it. The validity of this thesis is buttressed by the fact that almost half of all spending units have financial assets in excess of $750 to provide for the proverbial rainy days.

Stable Spending Habits

When incomes fall consumers do not revert to their previous spending habits – they resist cutbacks and try to maintain consumption in the face of lowered income by reducing their savings rates. This happened in both 1948-49 and 1953-54.

In short, consumer spending seems to have displayed a certain vitality and independence of its own – even in the face of recession. To a very great extent this reflects not only the significant improvements in the financial status of the American consumer, but also his deep-rooted confidence in the long-run future of the economy.





THE GROWTH OF SERVICES

Along with the growth of the U. S. economy over the years has gone a series of basic shifts in the importance of various occupations. Most dramatic of these shifts was the decline in the portion of our working force engaged in farming. As recently as 1880 half of all gainfully-employed persons worked on farms. Now only 10% of the labor force is in agriculture.

Thus, the century from 1820 to 1920 featured the transformation of the U. S. from a predominately farm economy to an industrialized one. The emphasis shifted from production of agricultural goods to turning out goods from factories.

Shift To Services

Now we are in the midst of an equally dramatic transformation — a shift from the production of goods to the provision of services of all sorts. Today almost three-fifths of the labor force is engaged in various service activities — trade, government, finance, transportation, electric power, medical care, recreation and the like.

- In 1940 these activities accounted for half of total employment; farming for another 20%; and manufacturing, mining and construction for the remaining 30%.
- In 1880 services accounted for 25% of the total, farming for 50% and the other activities for 25%.

The fact that we are becoming a service-oriented economy should cause no consternation. It is a sign of our steadily rising standard of living. In considerable measure, our ability to enjoy such services as travel, higher education, better medical care and similar amenities reflects our progress in raising productivity in goods-producing activities.

- In 1919 one farm worker produced enough to feed himself and nine other persons. Today he can support 20 others.
- Since 1919 the share of the non-farm labor force engaged in mining has declined more than 60%. In part, this stems from the shift from coal to oil and gas. But productivity in mining has soared.
- Output per man-hour in manufacturing has more than tripled in the same period, importantly because of the growing investment in better equipment.

The advance in productivity underlies the phenomenal increase in the purchasing power of the average family. With the rise in incomes has come the time and the means to supplement the basic necessities of food, clothing and shelter not only by more and better goods but also by an increasing flow of services.

Among these services have been those furnished by government. Thus, the proportion of the non-farm labor force employed by government has increased from 10% in 1919 to 13.8% in 1956. Most of this growth has occurred at the Federal level.

Productivity In Services

The trend towards services has raised the question of whether a slower rise in output per man-hour in these activities may not reduce the gains in the nation's over-all productivity and thus hold back the rate of general economic growth. The record since 1899 shows productivity in services has advanced at an average annual rate of 1½% whereas the rise for all private industries was 2½% per annum.

In this case, past trends may not be a reliable guide to the future. Some service industries have made great progress in increasing efficiency — examples are electric power, supermarkets and transportation. Moreover, the mushrooming use of business machines, the wonder drugs and improved methods of communication points to the possibility of substantial economies in services.

However, it seems clear that one of the challenges that lies ahead is that of performing services at a steadily rising level of efficiency. To maintain our over-all economic growth we need to seek maximum efficiency in the production of both goods and services.

Milk serves a growing America

Fluid and cool in tall glasses. Churned and fresh in nutritious butter pats. Skimmed and separated for rich cheeses and healthy ice creams—milk serves the nation in many ways.

And in many ways, too, America's commercial banks serve the dairy industry.

With money, credit and financial services, commercial banks help farmers produce milk. Commercial banks also help dairymen process, package and distribute milk and its many by-products. And ultimately it's the neighborhood banker who helps retailers stock milk and milk products for the entire community.

The Chase Manhattan Bank of New York, a leading lender to American industry, is proud to be a part of this banking system which helps keep our economy healthy and strong.

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